INVESTMENT COMPANY INSTITUTE

TESTIMONY OF PAUL SCHOTT STEVENS

PRESIDENT AND CEO

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

ON

"INDUSTRY PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS"

JULY 17, 2009

TABLE OF CONTENTS

I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $10.6 trillion and serve over 93 million shareholders. ICI is pleased to offer its perspectives on the Obama Administration's financial regulatory reform proposals.

This hearing takes place at a time when the United States and a host of other nations are still experiencing the effects of the most significant financial crisis in generations. In this country, the crisis has revealed significant weaknesses in our current system for oversight of financial institutions. At the same time, it has offered an important opportunity for robust dialogue about the way forward. And it provides policymakers with the public mandate needed to take bold steps to strengthen and modernize regulatory oversight of the financial services industry. We strongly commend the Obama Administration and the Congress for the attention they are devoting to examining the causes of the financial crisis and considering how the regulatory system can best be improved.

The outcome of these reform efforts will have a direct and lasting impact on the future of our financial system. The decisions you make will affect, among others, many millions of American investors who choose mutual funds, exchange-traded funds, and other registered investment companies (collectively, "funds") as vehicles to help them meet their long-term financial goals. Your actions also will affect funds themselves, which are among the largest investors in U.S. companies, holding about one quarter of those companies' outstanding stock. Funds also hold approximately 45 percent of U.S. commercial paper, an important source of short-term funding for corporate America, and about one third of tax-exempt debt issued by U.S.

municipalities. It is thus imperative to funds, as both issuers of securities to investors and purchasers of securities in the market, that our financial regulatory system works well to protect investors *and* to foster competitive and efficient capital markets.

Like other stakeholders, we have been thinking for much of the last year about how to revamp our current system so that our nation emerges from this crisis with stronger, well-regulated financial institutions operating within a fair, efficient, and transparent marketplace. In March, ICI released a white paper outlining detailed recommendations on how to reform the U.S. financial regulatory system, with particular emphasis on reforms most directly affecting the functioning of the capital markets and the regulation of investment companies.[1] Since that time, we have continued to develop and refine our own reform recommendations and to study proposals advanced by others.

In particular, we welcome the Administration's recent white paper outlining a wide-ranging framework for financial services regulatory reform.[2] The changes envisioned by the Administration's white paper are more significant and far-reaching than any since the New Deal. They deserve serious consideration and analysis by this Committee, other members of Congress, and all stakeholders in this debate. ICI has been reviewing these proposals carefully, and this testimony will highlight areas of agreement and disagreement with several of the Administration's recommendations.

Section II below addresses the Administration's proposal to create an additional independent federal agency, the Consumer Financial Protection Agency (CFPA), with broad

[1] *See* Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009), available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf ("ICI white paper").

[2] *See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf ("Administration white paper").

jurisdiction to protect consumers of certain financial products and services and to regulate the providers of such products and services. Section III addresses selected aspects of the Administration's proposed legislative language in its "Investor Protection Act of 2009," which would expand the Securities and Exchange Commission's authority and amend several of the statutes under its purview. Section IV highlights ICI's recommendations of ways to enhance the SEC's ability to protect investors and maintain the integrity of our nation's capital markets. Section V provides ICI's perspective on the appropriate role, composition, and scope of authority of a Systemic Risk Regulator. Finally, Section VI discusses selected other areas for reform, including the SEC's recently proposed recommendations for strengthening money market fund regulation, and ICI's suggestions for addressing certain regulatory gaps that have the potential to affect the capital markets and market participants.

II. PROPOSED CONSUMER FINANCIAL PROTECTION AGENCY

A. Genesis of the CFPA Concept

In evaluating the Administration's proposal for a new agency, it is helpful to reflect on the initial impetus for proposing such a body—the need to address deficiencies in consumer protection relating to credit products. More specifically, the proposal is rooted in a recommendation from a Congressional oversight panel chaired by Professor Elizabeth Warren. Earlier this year, the panel issued a special report on regulatory reform, in which it offered a series of recommendations for "improving oversight, protecting consumers, and ensuring stability."[3] In a section entitled "Create a New System for Federal and State Regulation of Mortgages and Other Consumer Credit Products," the report makes the case that "ineffective regulation of mortgages and other consumer credit products has produced unfair, and often

[3] *See* Congressional Oversight Panel, *Special Report on Regulatory Reform* (Jan. 2009) ("Warren panel report"), available at http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

abusive, treatment of consumers, which destabilizes both families and the financial institutions that trade in those products."[4] As examples, the report cites the rise of subprime mortgages with "exotic and often predatory new features," consumers' inability to understand legally required disclosure documents, and the impossibility of making meaningful comparisons among different mortgage products.

Against this backdrop of abusive practices, the report recommends the creation of a single federal agency with "the responsibility and accountability for drafting, implementing and overseeing effective consumer credit protection rules."[5] The report offers two options for structuring the new regulator—either as an independent agency, or within the Federal Reserve Board. The report indicates that "[p]lacing the new regulator within the [Federal Reserve] Board would keep safety and soundness and consumer protection responsibilities together, on the ground that each responsibility, if properly implemented, could complement and reinforce the other."[6] The suggestion to vest this responsibility within the Federal Reserve underscores that the CFPA proposal was inspired by the need to supplement banking regulators' ability to adequately protect consumers.

B. The Administration's CFPA Proposal

The Administration has set forth a broader vision of the CFPA. In both its white paper and its draft statutory language, the Administration envisions an agency that would "protect consumers of credit, savings, payment and other consumer financial products and services, and

---

[4] *Id.* at 30.

5 *Id.* at 34. In recent testimony before this Committee, Professor Warren reaffirmed the original concept behind the CFPA: "[W]e are here today because of a problem that can be explained in five blunt words: the credit market is broken . . . I'm happy to be here today to talk about how I think we can help fix the broken credit market. And I can sum it up in four words: the Consumer Financial Protection Agency." Written Testimony of Elizabeth Warren, Professor of Law, Harvard Law School, before the House Financial Services Committee, Hearing on "Regulatory Restructuring: Enhancing Consumer Financial Products Regulation" (June 24, 2009).

[6] Warren panel report, *supra* note 3, at 35.

to regulate all providers of such products and services." But in discussing the specifics of why this new agency is needed, the Administration, like the Warren panel report, focuses above all on financial products offered to consumers by banks and their non-bank competitors such as mortgage companies. In its white paper, for example, the Administration highlights the fragmentation of consumer protection among the four federal banking agencies, the fact that the expertise and culture of the banking agencies is oriented to institutions and markets as opposed to consumers, and the limited tools and resources available to the Federal Trade Commission—which has a consumer protection mission—to supervise nonbank institutions. Recent testimony about the CFPA by a key Treasury Department official likewise focuses on current shortcomings with regard to the regulation and oversight of consumer products offered by banks, thrifts, credit unions, and their non-bank competitors:

> Instead of leadership and accountability, there is a fragmented system of regulation designed for failure. Bank and non-bank financial service providers often compete vigorously in the same consumer markets but are subject to two different and uncoordinated federal regimes—one based on examinations and supervision, the other based on after-the-fact investigations and enforcement actions. . . . Fragmentation of the supervision of banks and thrifts only makes the problem worse: a banking institution can choose the least restrictive among several different supervisory agencies. Despite best intentions, "regulatory arbitrage" inevitably weakens protections for consumers and feeds bad practices.[7]

The testimony then offers several examples by way of illustration: mortgages, credit cards, payday loans, auto loans, car title loans, and overdraft policies.[8]

The Administration has clearly crafted its proposal with the intention of keeping investor-oriented regulation—including in particular regulation of the fund industry—*outside* the

---

[7] Testimony of Michael Barr, Assistant Secretary for Financial Institutions, Department of the Treasury, before the House Committee on Energy and Commerce, Subcommittee on Commerce, Trade and Consumer Protection, Hearing on "The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC" (July 8, 2009), available at http://www.treas.gov/press/releases/tg199.htm.

[8] *Id.*

jurisdiction of the new agency. The Administration's white paper expressly states that the CFPA would *not* have authority with respect to "investment products and services already regulated by the SEC and [the Commodity Futures Trading Commission]," and its draft legislation contains explicit exclusions for any fund, investment adviser, or broker-dealer required to be registered with the SEC. Moreover, the Administration is separately recommending a series of reforms to "improve the SEC's ability to protect investors, focusing on principles of transparency, fairness, and accountability." These recommendations include initiatives that are intended to provide greater protection for individual (retail) investors.

C. Why Funds and Their Service Providers Are Appropriately Regulated by the SEC

As the Administration has correctly recognized, the CFPA should not have jurisdiction over funds and their investment advisers, because they are already appropriately regulated by the SEC. The same should be true for other service providers to funds that are also under the SEC's jurisdiction.[9]

Funds—as both issuers of securities and as significant investors in the capital markets—are subject to a comprehensive regulatory framework that has worked extremely well for almost 70 years. This framework, which was created by Congress in the wake of our nation's last great financial crisis, includes the four major federal securities laws: the Securities Act of 1933; the Securities Exchange Act of 1934; the Investment Advisers Act of 1940; and the Investment Company Act of 1940. These four statutes, and the extensive SEC rulemaking that flows from them, govern how funds are structured, their day-to-day operations, the types and frequency of disclosures that funds must make to investors, purchases and sales of securities for fund

[9] Subsection D below recommends that Congress include an explicit exclusion for any SEC-regulated entity acting in its regulated capacity.

portfolios, sales of fund shares to investors, permitted and prohibited activities by fund service providers, and so on. Even more important than the breadth of this regulatory framework is its common focus—on protecting investors and maintaining the integrity of our nation's capital markets.

While not immune from problems, this robust and developed system of regulation has proven to be extraordinarily successful in safeguarding investor interests while also allowing for the growth of a competitive and innovative fund industry. As a prime example, funds are subject to more extensive disclosure and transparency requirements than any other financial product. The SEC, with the strong support of investor advocates and the fund industry, has devoted substantial time and resources to making mutual fund disclosure easily accessible, understandable and useful to investors.[10] Hallmarks of this disclosure include clear, standardized disclosure of fund fees and expenses in a table at the front of a fund's prospectus and risk disclosure written in plain English. The availability of clear disclosure helps to ensure that fund shareholders understand their investments and can make educated choices.

This regulatory framework has proven remarkably resilient through difficult market conditions and has shielded fund investors from many of the problems associated with other financial products and services. The greater discipline that has worked so well in core areas of fund regulation—such as daily mark-to-market valuation, tight leveraging restrictions, clear and prominent risk disclosure, independent custody, independent director oversight, and affiliated

---

[10] *See, e.g., Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, SEC Release No. IC-28584 (Jan. 13, 2009), 74 Fed. Reg. 4546 (Jan. 26, 2009), available at http://www.sec.gov/rules/final/2009/33-8998.pdf (adoption of rule changes requiring funds to include a new "summary section" at the beginning of each prospectus and permitting funds to use a "summary prospectus" to provide key fund information to investors, while making additional information available online or in paper upon request).

transaction prohibitions—may well provide a model for the oversight of other participants in the financial markets.

This regulatory framework, moreover, extends far beyond funds themselves. A fund typically has no employees; its operations are carried out by service providers such as the fund's investment adviser, principal underwriter, and transfer agent. These entities, and the functions that they perform for funds, are also regulated by the SEC, as are the broker-dealer firms that sell fund shares. Large volumes of fund share transactions are cleared and settled through the National Securities Clearing Corporation (NSCC), also regulated by the SEC. And two types of funds—exchange-traded funds and closed-end funds—trade on securities exchanges that operate in accordance with, and impose on listed companies including funds, rules that are subject to SEC approval. The SEC thus has comprehensive regulatory authority under the federal securities laws over funds, their service providers, and various other market participants (such as clearing agencies) whose services are integral to fund operations.

The unique characteristics of funds' structure and operations would make it very difficult as a practical matter to separate fund regulation from all other aspects of their oversight performed by the SEC. A separate regulatory regime for funds under the CFPA could well mean that funds—and their boards, advisers, and distributors—would find themselves subject to conflicting regulatory philosophies and potential regulatory overlap. Either of these results would be burdensome and inefficient. Ironically, such a system could also lead to *gaps* in regulation, because it would be impossible to draw clear lines of authority over funds between the CFPA and the SEC.[11]

[11] SEC Chairman Mary Schapiro has expressed similar sentiments about the idea of a separate consumer protection regulator being given authority over funds and their service providers currently regulated by the SEC. *See* Yin Wilczek, *Schapiro: Discussions Still Ongoing Over SEC Authority in Pending Reform*, BNA Securities Regulation and Law Report, Vol. 41, No. 21, at 960 (May 25, 2009) (stating that the SEC's authority over mutual funds, fund

There are gaps and other weaknesses in the financial regulatory system that must be addressed. But the regulation of funds has not been one of them. In fact, the fundamental investor protection provisions in the Investment Company Act and the other federal securities laws have withstood the test of time. For all of the foregoing reasons, ICI strongly believes that the SEC continues to be the appropriate regulatory standard setter for funds and their service providers.

D. Recommended Clarifications to the Administration's CFPA Proposal

a. Explicit Exclusion for All SEC-Regulated Entities

The Administration's white paper expressly states that the CFPA would *not* have authority with respect to "investment products and services already regulated by the SEC and CFTC." As discussed above, in the fund context, the "investment services" regulated by the SEC include the full range of services integral to fund operations—services provided not only by investment advisers and broker dealers, but also by entities such as transfer agents, custodians, and clearing agencies. The Administration's draft legislation, however, does not sufficiently provide for this intended exclusion. ICI accordingly recommends that the legislation's definition in Section 1022(f)(2)(A) of "person regulated by the SEC" be extended to cover any SEC-regulated entity acting in its regulated capacity. This exclusion not only would better reflect the Administration's original intent, but would avoid the ambiguity that undoubtedly would accompany attempts to parse the federal securities laws in an effort to identify each and every entity and activity that would remain under the SEC's jurisdiction. Failure to draw the lines clearly and properly would result in overlapping—and very possibly conflicting authority—over entities and activities that were overlooked.

---

disclosures, and investment management services related to funds "cannot be separated into simple little pieces and moved over to another agency" and that "[t]hose things should remain with the integrated capital markets regulator.").

b. Explicit Exclusions for Tax-Favored Retirement and Education Savings Vehicles

Regulating activities in connection with 401(k) plans, IRAs, 529 plans, and similar tax-favored retirement and educational savings vehicles through a new regulator would be far afield from the Administration's intent to address deficiencies in consumer protection for credit and related products offered by banks, thrifts, credit unions and their non-bank competitors. We are pleased that there is nothing in the public statements of the Administration to suggest that the Administration contemplates extending the jurisdiction of the new regulator to tax-favored savings vehicles and their service providers. Congress should explicitly exclude these entities in any eventual legislation.

Vesting jurisdiction in the CFPA over retirement and education savings vehicles would be ill-advised and disruptive of long-standing and effective regulatory regimes. Congress has already provided for the regulation of retirement and eligible deferred compensation plans and arrangements under the tax laws in sections 401(a), 401(k), 403(a), 403(b), 457(b), 408, and 408A of the Internal Revenue Code ("Code") and in the Employee Retirement Income Security Act ("ERISA"), and has provided for the regulation of educational savings arrangements under section 529 of the Code.

The regulatory framework under the Code, which has existed and been strengthened over a period of more than 60 years (and was extensively expanded in ERISA 35 years ago), imposes strict conditions on obtaining tax-favored treatment, and severe tax consequences for the failure to meet these requirements. These requirements are substantive and oriented to investor protection. The Code also sets out prohibited transaction and disclosure rules, and imposes significant penalties in the form of excise taxes for violations of those requirements.

ERISA, which was enacted in 1974, sets forth reporting requirements (*e.g.*, Form 5500 annual report) and disclosure requirements (*e.g.*, summary plan description, periodic benefit statements, existing and proposed requirements on investment product disclosure) designed to assure that the operations of retirement plans are transparent and that participants have clear and user-friendly information with which to understand and make decisions about their plans. ERISA also contains detailed rules governing the operation of employee benefit plans that apply to those who act on behalf of the plan (plan fiduciaries) and to custodians, trustees, and other service providers. Assets of an ERISA-covered plan must be held in trust for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of the plan. In addition, plan fiduciaries must meet strict fiduciary duties in the exercise of their responsibilities, including duties of care and loyalty, and must assure that plan service arrangements are reasonable and provide for no more than reasonable compensation. Moreover, ERISA provides for a series of publicly and privately enforced civil remedies (as well as certain criminal penalties) for violations of ERISA rules.

In administering the applicable laws, the Department of Labor, the Treasury Department and the IRS focus on assuring that these arrangements operate *solely* in the interest of the participants and beneficiaries. The Treasury Department and the IRS also are charged with assuring that the tax benefits of the arrangements are not abused, a mission fully compatible with protecting participants and beneficiaries.

With respect to 529 plans, in addition to the rigorous standards imposed on these plans under the Code, rules of the Municipal Securities Rulemaking Board, which must be approved by the SEC, ensure that investors are provided with comprehensive and current information

concerning the products and that sellers of these products abide by standards of conduct designed to protect investors.

Creating any measure of parallel jurisdiction in the CFPA over these matters would serve no consumer protection purpose but would create a burdensome and inefficient structure that could subject plans and their service providers to conflicting regulatory philosophies and potential regulatory overlap. For example, although the exclusion for SEC-regulated entities would prevent the CFPA from asserting jurisdiction over funds, the agency might assert jurisdiction over certain aspects of the use of investment products, including mutual funds, in 401(k) plans and IRAs. Because almost half of the assets held in 401(k) plans and IRAs today are invested in mutual funds, the potential regulatory tug of war between the retirement regulators (the Treasury Department, the IRS, and the Department of Labor), the SEC, and CFPA predictably would produce significant confusion and potential conflicts.

c. CFPA Jurisdiction Generally

As the foregoing discussion illustrates, it will be important for Congress—if it establishes the CFPA—to delineate as clearly as possible its lines of jurisdiction, and to provide strong oversight of the new agency in order to prevent any jurisdictional "creep." Our financial markets are dynamic, and new products and services will continue to be introduced. As a result, the lines now drawn for the CFPA could, absent very careful consideration, become less clear over time.

By way of analogy, when the CFTC was established in the mid-1970s, agricultural products accounted for most of the total U.S. futures exchange trading volume. By the late 1980s, a shift from the predominance of agricultural products to financial instruments and currencies was readily apparent in the volume of trading on U.S. futures exchanges. As new, innovative financial instruments were developed, the lines between securities and futures often

became blurred. The existing, divided regulatory approach has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection between CFTC and SEC jurisdiction. In fact, a separate component of the Administration's reform plan is devoted to addressing these very problems.

III. NECESSARY REFINEMENTS AND IMPROVEMENTS TO THE INVESTOR PROTECTION ACT OF 2009

The Administration has also prepared separate draft legislation addressing several issues relating directly to SEC authority and amending several statutes under its purview. The "Investor Protection Act of 2009" contains two provisions that, as currently drafted, present serious concerns to ICI. First, the requirement that *fund* disclosure be delivered at or before the time of sale is highly problematic. ICI has long supported point of sale disclosure, but for *all* retail investment products. Second, the standard of "conduct"—rather than an explicit fiduciary duty—proposed for broker-dealers and investment advisers, may not be sufficient to fully protect the millions of investors who rely on these intermediaries for advice.

A. Broaden the Scope of Point of Sale Disclosure

The Investor Protection Act would fundamentally change the way funds—and only funds—are sold. As previously discussed, funds and their investors have weathered the financial crisis better than many other market participants. We are deeply troubled, therefore, that the Investor Protection Act would apply only to funds in authorizing the SEC to designate the documents or information that must precede a sale to a purchaser of securities. We have long supported the concept of enhanced disclosure to investors at the time they are making investment decisions, but limiting this point of sale disclosure requirement to funds provides incomplete investor protection and may in practice disserve investors. Such rules could create strong

incentives for brokers and other intermediaries to recommend other investment products not subject to the same regulatory burdens, such as variable annuity contracts, collective investment trusts and separate accounts, even when those products do not offer the same level of regulatory protection and other benefits for investors.

Regulators and consumer advocates alike have expressed concerns about this likely result. Former NASD Chairman Robert Glauber, for example, has stressed the need to consider this consequence, explaining that "[a]n investor should be sold a security because it's right for him or her, not because it's easier to sell than something else."[12] Similarly, Barbara Roper of the Consumer Federation of America stated that by considering certain fee disclosures as "a mutual fund issue, instead of a broker compensation issue, sort of more holistically, you run the risk that you make mutual funds less attractive to sell. And I think that would be a very bad thing."[13]

We therefore strongly believe that any point of sale disclosure obligation should be product-neutral. The policy goals underlying point of sale disclosure—assuring that investors understand their investment and the compensation arrangements of those recommending the investment—are no less valid for other types of investments. If investors would benefit from receiving certain information earlier in the sales process, providing that information should be required for all retail investment products, not just funds.[14]

---

[12] Remarks by Robert Glauber, Chairman, NASD, at the Investment Company Institute's 2006 General Membership Meeting (May 18, 2006), available at http://www.finra.org/PressRoom/SpeechesTestimony/RobertR.Glauber/p016642.

[13] Remarks by Barbara Roper, Director of Investor Protection, Consumer Federation of America, at the Securities and Exchange Commission 12b-1 Roundtable, Unofficial Transcript, p. 196, available at http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf.

[14] ICI did not support an earlier SEC point of sale proposal because other financial products would not be subject to the same requirements and also because it was inconsistent with the manner in which brokers sell mutual fund shares. *See* Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Mr. Jonathan Katz, Secretary, U.S. Securities and Exchange Commission, dated Apr. 4, 2005.

Crafting rules for all retail investment products would be a substantial undertaking, but that challenge should not permit regulators to shrink from making the difficult decisions necessary to bring these protections to investors in all retail investment products. For example, the appropriate substance of the disclosure, which we believe must include information about intermediary compensation and potential conflicts of interest, must be determined. The SEC's recently adopted summary prospectus proposal—which the Administration's white paper points to as a possible point of sale document—was not designed to provide this information. Rather, the summary prospectus contains important information about a *fund*, which may be sold through a variety of intermediary channels with a range of attendant costs. The challenges of developing a workable and useful point of sale document are evidenced by the fact that the SEC's previous point of sale initiative, which did not extend to all retail investment products, has been underway for more than five years.[15]

We would further emphasize that any point of sale disclosure requirement must be designed to minimize disruptions to the sales process. Investment sales typically occur by telephone or over the Internet, rather than through face-to-face meetings, so the physical transfer of a document is not realistic. Any point of sale disclosure requirement should provide investors with timely and convenient access to the required information without impeding investors' ability to conduct transactions and without imposing inappropriate costs and burdens on intermediaries. For all of these reasons, we strongly oppose a point of sale disclosure regime that focuses solely on funds.

---

[15] *See* Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, SEC Release Nos. 33-8358; 34-49148; IC-26341 (Jan. 29, 2004) [69 Fed. Reg. 6438 (Feb. 10, 2004)]; Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds Reopening of Comment Period and Supplemental Request for Comment, SEC Release Nos. 33-8544; 34-51274; IC-26778 (Feb. 28, 2005) [70 Fed. Reg. 10521 (March 4, 2005)].

B. Standard of Care for Investment Advice

Over the last decade, brokers have significantly shifted their business model to include providing investment advice and charging fees based on assets under management, rather than commissions for each transaction. This model previously had been used solely by investment advisers. With the change in brokers' business practices, many investors have become confused about the type of entity providing advice, and the disparate level of protection they may receive depending on the "hat" the intermediary wears. Many, including ICI, have called for clarity for investors seeking investment advice—if broker-dealers and investment advisers are providing virtually identical services to retail investors, the rules and principles governing those activities should be identical as well.

Defining the boundaries of "harmonization" will not be an easy task, but some general principles should guide the debate. First, there must be recognition that brokers have changed their business practices to become more like advisers—who have generally been successfully regulated under the Investment Advisers Act of 1940 for nearly seven decades. "Harmonization" that seeks to make advisers more like brokers has no foundation in investor protection. Second—and following directly from the first principle—the standard that governs the provision of investment advice must be one that explicitly incorporates the fiduciary duty that governs investment advisers' dealings with their clients. Anything less will fall short of the investor protections currently enjoyed by advisory clients. Section 913(b) of the draft legislation attempts to describe a standard that appears to be "in substance" similar to a fiduciary duty. But it fails to state expressly that brokers and advisers alike must act as fiduciaries. In effect, it would dilute the protections currently provided to advisory clients.[16] A statute that purports to

[16] We note that the title of Section 913 does appear to establish a fiduciary duty, but the text of Section 913(b) neglects to use the term. If it is the Administration's intent to impose a fiduciary duty, it should so clearly state.

protect investors must not lower standards and weaken protections they have historically enjoyed.

Chairman Schapiro has endorsed such a fiduciary standard, stating: "I therefore believe that all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients."[17] Others have observed that a fiduciary standard "has real teeth because it is an affirmative obligation of loyalty and care that continues through the life of the relationship between the adviser and the client, and it controls all aspects of their relationship. It is not a check-the-box standard that only periodically applies."[18]

IV. ENSURING EFFECTIVE CAPITAL MARKETS REGULATION

Currently, securities and futures—and their respective markets and market participants—are subject to separate regulatory regimes administered by two very different federal regulators. This system reflects historical circumstances but is out of step with the increasing convergence of these two industries. It has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection. In its March white paper, ICI recommended the creation of a Capital Markets Regulator as a new independent federal agency that would encompass the combined functions of the SEC and those of the CFTC that are not agriculture-related, with the goal of bringing a consistent policy focus to U.S. capital markets.

In its own white paper, the Administration acknowledges these same shortcomings with the current system but stopped short of recommending a merger of the two agencies, presumably

---

[17] Speech by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009).

[18] Speech by Commissioner Luis A. Aguilar, *SEC's Oversight of the Adviser Industry Bolsters Investor Protection* (May 7, 2009).

in recognition of the practical obstacles to such a regulatory consolidation. Instead, the Administration has called upon the SEC and CFTC to recommend changes to existing statutes and regulations aimed at harmonizing the regulation of economically equivalent financial instruments. We understand that the two agencies have begun these discussions, and we look forward to reviewing the agencies' recommendations.

Many of ICI's recommendations on how to fashion an effective Capital Markets Regulator may just as appropriately be applied to the SEC. Most importantly, we recommend that the agency remain sharply focused on investor protection and law enforcement, as distinct from the safety and soundness of regulated entities. The SEC also must remain focused on maintaining the integrity of the capital markets, which will benefit both market participants and investors. Congress should ensure that the agency is given the resources it needs to fulfill its mission.[19] Further, the SEC must have the ability to attract personnel with the necessary market experience to fully grasp the complexities of today's global marketplace.

Paying careful attention to how the SEC is organized and managed will yield large dividends in terms of enhancing the agency's effectiveness. ICI's white paper outlines several recommendations in this regard, including the need for high-level focus on management of the agency. We stress the importance, for example, of the agency's having open and effective lines of internal communication, mechanisms to facilitate internal coordination and information sharing, and a comprehensive process for setting regulatory priorities and assessing progress.

We commend Chairman Shapiro for moving aggressively to strengthen the SEC and restore the agency's reputation for excellence. We were particularly pleased with the Chairman's recent announcement of her intention to retain a chief operating officer to manage

[19] *See* Investment Company Institute, Statement on the U.S. Securities and Exchange Commission's Appropriations for Fiscal Year 2010, submitted to the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. Senate (June 9, 2009).

the SEC's internal operations, a step that is consistent with our white paper recommendations.[20] We likewise are heartened by the Chairman's commitment to hiring more agency staff with significant industry experience, which will help the agency to stay abreast of market and industry developments.[21]

As outlined in ICI's white paper, there are other ways in which the SEC could seek to maximize its effectiveness in performing its responsibilities. Three of our most significant suggestions are briefly mentioned here. First, ICI believes the SEC would benefit from developing close, cooperative interaction with the entities it regulates as a means to identify and resolve problems, to determine the impact of problems or practices on investors and the market, and to cooperatively develop best practices that can be shared broadly with market participants. Incorporating a more preventative approach would likely encourage firms to step forward with self-identified problems and proposed resolutions, and could be accomplished in a way that would not weaken the agency's strong enforcement program. Second, the SEC should establish a variety of mechanisms to stay abreast of market and industry developments, in addition to hiring staff with considerable industry experience. For example, the agency could establish a multidisciplinary "Capital Markets Advisory Committee" comprised of private-sector representatives from all major sectors of the capital markets. Third, the SEC will be best positioned to accomplish its mission if it conducts economic analysis in various aspects of its work, including rulemaking, examinations, and enforcement. From helping the agency look at

---

[20] *See* Statement of Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Before the Subcommittee on Financial Services and General Government, U.S. Senate Committee on Appropriations (June 2, 2009).

[21] *See SEC Announces New Initiative to Identify and Assess Risks in Financial Markets* (April 30, 2009), available at http://www.sec.gov/news/press/2009/2009-98.htm.

broad trends that shed light on how markets or individual firms are operating to enabling it to demonstrate that specific policy initiatives are well-grounded, developing the SEC's capability to conduct economic analysis will be well worth the long-term effort required.

V. SYSTEMIC RISK REGULATION

A. General Observations

The ongoing financial crisis has highlighted the vulnerability of our financial system to risks that have the potential to spread rapidly throughout the system and cause significant damage. Over the past year, various policymakers, financial services industry representatives, and other commentators have called for the establishment of a formal mechanism for identifying, monitoring, and managing these risks. A mechanism that will allow federal regulators to look across the system should equip them to better anticipate and address such risks.

ICI was an early supporter of creating a systemic risk regulator. But we also have long advocated that two important cautions should guide Congress in determining the composition and authority of a systemic risk regulator.[22] First, the legislation establishing a systemic risk regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system that may stifle innovations, impede competition or impose needless inefficiencies. Second, a systemic risk regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking or insurance.

Legislation establishing a systemic risk regulator should clearly define the nature of the relationship between this new regulator and the primary regulator(s) for the various financial sectors. It should delineate the extent of the authority granted to the systemic risk regulator, as

[22] *See, e.g.*, ICI white paper, *supra* note 1.

well as identify circumstances under which the systemic risk regulator and primary regulator(s) should coordinate their efforts and work together. We believe, for example, that the primary regulators should act as the first line of defense in detecting potential risks within their spheres of expertise.

In view of the two cautions outlined above, ICI was an early proponent of structuring a systemic risk regulator as a statutory council comprised of senior federal regulators. In March, I testified at a Senate Banking Committee hearing focused on investor protection and the regulation of securities markets. My observations about establishing a systemic risk council—and those of another witness on the panel, Damon Silvers of the AFL-CIO—were favorably received by both the Committee Chairman and Ranking Member.[23] Following the hearing, the Committee asked ICI to elaborate, both in writing and by briefing the Committee, about the structure and organization of a systemic risk council, and the positives and negatives of this approach to systemic risk regulation.[24] Since that time, there has been growing support for such an approach, both from federal and state regulators and others.[25]

B. The Administration's Proposed Approach to Systemic Risk Regulation

In view of ICI's support for a council approach to systemic risk, we were pleased to see that the Administration's white paper includes recommendations for a Financial Services Oversight Council. The Council would be charged with monitoring for emerging threats to the

---

[23] *See, e.g.*, Opening Statement of Chairman Christopher J. Dodd, "Enhancing Investor Protection and the Regulation of Securities Markets, Part II," Senate Committee on Banking, Housing and Urban Affairs (March 26, 2009), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=3412e671-6b45-4b4c-b5ba-2749de825dbe.

[24] ICI's recommendations on how to structure a systemic risk council are set forth in Subsection C below.

[25] *See, e.g.*, Statement of Sheila C. Bair Chairman, Federal Deposit Insurance Corporation, before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on "Regulating and Resolving Institutions Considered 'Too Big To Fail'" (May 6, 2009) ("Bair Testimony"); Senator Mark R. Warner, "A Risky Choice for a Risk Czar," *Washington Post* (June 28, 2009).

stability of the financial system, and would have authority to gather information from the full range of financial firms to enable such monitoring. As envisioned by the Administration, the Council also would serve to facilitate information sharing and coordination among the principal federal financial regulators, provide a forum for consideration of issues that cut across the jurisdictional lines of these regulators, and identify gaps in regulation.[26] In our white paper, we observe that the stronger links between regulators and the sense of shared purpose that would grow out of these collaborative efforts would greatly assist in sound policy development, prioritization of effort, and cooperation with the international regulatory community.

The Administration's proposal would nonetheless vest the lion's share of authority and responsibility for systemic risk regulation with the Federal Reserve, relegating the Council to at most an advisory or consultative role. In particular, the Administration recommends granting broad new authority to the Federal Reserve, including: (1) the ultimate voice in determining which financial firms would potentially pose a threat to financial stability, through its designation of so-called "Tier 1 Financial Holding Companies"[27]; (2) the ability to collect reports from all financial firms meeting minimum size thresholds and, in certain cases, to examine such firms, in order to determine whether a particular firm should be classified as a Tier 1 FHC; (3) consolidated supervisory and regulatory authority over Tier 1 FHCs and their subsidiaries, including the application of stricter and more conservative prudential standards[28]

[26] *See* Administration white paper, *supra* note 2, at 18.

[27] The Administration proposes requiring the Federal Reserve to consider certain specified factors and to get input from the Council; the Federal Reserve, however, would have discretion to consider other factors, and the final decision of whether to designate a particular firm for Tier 1 FHC status would be its alone.

[28] As noted in the Administration's white paper, the Federal Reserve is currently constrained by the Gramm-Leach-Bliley Act from imposing higher prudential requirements or more stringent activity restrictions on subsidiaries of bank holding companies that already have a primary regulator (*e.g.*, broker-dealers and investment advisers subject to SEC regulation).

than those applicable to other financial firms; and (4) the role of performing "rigorous assessments of the potential impact of the activities and risk exposures of [Tier 1 FHCs] on each other, on critical markets, and on the broader financial system."[29] The Administration's white paper acknowledges that "[t]hese proposals would put into effect the biggest changes to the Federal Reserve's authority in decades."[30]

ICI believes that the Administration's approach would strike the wrong balance, by expanding the mandate of the Federal Reserve well beyond its traditional areas of expertise and failing to draw appropriately on the expertise of the other federal functional regulators. The Administration's white paper fails to explain why its proposed identification and regulation of Tier 1 FHC is appropriate in view of concerns over market distortions that could accompany "too big to fail" designations. Further, the standards that would govern determinations of Tier 1 FHC status are highly ambiguous.

The shortcomings that we see with the Administration's plan reinforce ICI's belief that a properly structured statutory council would be an effective mechanism to orchestrate and oversee the federal government's efforts to monitor for potential systemic risks and mitigate the effect of such risks. Below, we set forth our detailed recommendations for the composition, role and scope of authority that should be afforded to such a council.

C. Fashioning an Effective Systemic Risk Council

In concept, a "Systemic Risk Council" would be similar to the National Security Council (NSC), which was established by the National Security Act of 1947. In the aftermath of World War II, Congress recognized the need to assure better coordination and integration of "domestic,

[29] *See* Administration white paper, *supra* note 2, at 24.

[30] *Id.* at 25.

foreign, and military policies relating to the national security" and the ongoing assessment of "policies, objectives, and risks." The 1947 Act established the NSC under the President as a Cabinet-level council with a dedicated staff. In succeeding years, the NSC has proved to be a key mechanism used by Presidents to address the increasingly complex and multi-faceted challenges of national security policy. It was my honor from 1987-1989 to serve as statutory head (*i.e.*, Executive Secretary) of the NSC staff.

As with national security, addressing risks to the financial system at large requires diverse inputs and perspectives. A Systemic Risk Council's membership accordingly should draw upon a broad base of expertise, and should include at a minimum the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, and the heads of the federal bank and capital markets regulators (and insurance regulator, if one emerges at the federal level). As with the NSC, flexibility should exist to enlist other regulators into the work of the Council on specific issues as required—including, for example, state regulators and self-regulatory organizations.

By statute, the Council should have a mandate to monitor conditions and developments in the domestic and international financial markets, to assess their implications for the health of the U.S. financial system at large, to identify regulatory actions to be taken to address systemic risks as they emerge, to assess the effectiveness of these actions, and to advise the President and the Congress on emerging risks and necessary legislative or regulatory responses. The Council would be responsible for coordinating and integrating the national response to systemic financial risks, but it would not have a direct operating role (much as the NSC coordinates and integrates military and foreign policy that is implemented by the Defense or State Department and not by the NSC itself). Rather, responsibility for addressing identified risks would lie with the existing

functional regulators, which would act pursuant to their normal statutory authorities but under the Council's direction.

The Secretary of the Treasury, as the senior-most member of the Council, should be designated chairman. An executive director, appointed by the President, should run the day-to-day operations of the council and serve as head of the Council's staff. The Council should meet on a regular basis, with an interagency process coordinated through the Council's staff to support and follow through on its ongoing deliberations.

To accomplish its mission, the Council should have the support of a dedicated, highly-experienced staff. The staff should represent a mix of disciplines (*e.g.*, economics, accounting, finance, law) and should consist of individuals seconded from government departments and agencies (federal and state), as well as recruited from the private sector with a financial services business, professional or academic background. As with the NSC, the staff's focus would be to support the work of the Council as such, and thus the staff would operate independently from the functional regulators.[31] Nonetheless, the background and experience of the staff would help assure the kind of strong working relationships with the functional regulators necessary for the Council's success. Such a staff could be recruited and at work in a relatively short period of time. The focus in recruiting such a staff should be on quality, not quantity, and the Council's staff accordingly need not and should not be large.

Advantages of a Systemic Risk Council:

- The proposed Council would avoid risks inherent in designating an existing agency like the Federal Reserve to serve essentially as an all-purpose systemic risk regulator. In such a role, the Federal Reserve understandably may tend to view risks and risk mitigation

[31] A Council designed in this way would be markedly different from the Administration's Financial Services Oversight Council, which would reside within the Treasury Department.

through its lens as a bank regulator focused on prudential regulation and "safety and soundness" concerns, potentially to the detriment of consumer and investor protection concerns and of non-bank financial institutions. A Systemic Risk Council would bring all competing perspectives to bear and, as a result, would be likely strike the proper balance.

- Systemic risks may arise in different ways and affect different parts of the domestic and global financial system. No existing agency or department has a comprehensive frame of reference or the necessary expertise to assess and respond to any and all such risks. Creating such an all-purpose systemic risk regulator would be a long and complex undertaking, and would involve developing expertise that duplicates that which exists in today's functional regulators. The Council by contrast would enlist the expertise of the entire regulatory community in identifying and devising strategies to mitigate systemic risks. It also could be established and begin operation much more quickly.

- A Council would provide a high degree of flexibility in convening those federal and state regulators whose input and participation is necessary to addressing a specific issue, without creating an unwieldy or bureaucratic structure. As is the case with the NSC, the Council should have a core membership of senior federal officials and the ability to expand its participants on an ad hoc basis when a given issue so requires.

- With an independent staff dedicated solely to pursuing the Council's agenda, the Council would be well positioned to test or challenge the policy judgments or priorities of various functional regulators. Moreover, by virtue of their participation on the Council, the various functional regulators would themselves likely be more attentive to emerging risks or regulatory gaps. This would help assure a far more coordinated and integrated

approach. Over time, the Council also could assist in framing a political consensus about addressing significant regulatory gaps and necessary policy responses.

- This model anticipates that functional regulators, as distinct from the Council itself, would be charged with implementing regulations to mitigate systemic risks as they emerge. This operational role is appropriate because the functional regulators have the greatest knowledge of their respective regulated industries. Nonetheless, the Council and its staff would have an important independent role in evaluating the effectiveness of the measures taken by functional regulators to mitigate systemic risk and, where necessary, in prompting further actions.

- The Council as outlined above could have two separate but interrelated mandates—systemic risk and policy coordination/information sharing across the various functional regulators. We believe this model, where all the functional regulators have an equal voice and stake in the success of the Council, would better accomplish this goal than a structure, such as the one the Administration has proposed, with one regulator—the Federal Reserve—having far more influence that the others. Further, the staffing and resources of the Council could be leveraged for both purposes. This would address some of the criticisms and limitations of the existing President's Working Group on Financial Markets.

Potential Criticisms—and How They Can Be Addressed:

- It has been argued that, because of the Federal Reserve's unique crisis-management capability as the central bank and lender of last resort, it is the only logical choice as a systemic risk regulator. To be sure, when we encounter serious financial instability, the Federal Reserve's authorities are indispensible to remedy the problems. But the purpose

of systemic risk regulation should be to identify in advance, and prevent or mitigate, the causes of such instability—a role to which the Council would seem best suited.

- A potential criticism of the council structure is that it may diffuse responsibility and pose difficulties in assuring proper follow-through by the functional regulators. While it is true that each functional regulator would have responsibility for implementing responses to address identified risks, it must be made clear in the legislation creating the Council (and in corresponding amendments to the organic statutes governing the functional regulators) that these responses must reflect the policy direction determined by the Council. Additionally, as suggested by FDIC Chairman Bair, the Council should have the authority to require a functional regulator to act as directed by the Council.[32] In this way, Congress would be assured of creating a Systemic Risk Council with "teeth."

- A related criticism of the council structure may be that it presents the potential for inaction, if its members are unable to reach agreement on a course of action. We believe that this potential could be easily foreclosed by specifying, in the authorizing legislation, a mechanism that requires the elevation of disputes to the President for resolution and/or assures strong Congressional oversight through periodic reporting to Congress of such disputes and their resolution.

VI. SELECTED OTHER AREAS FOR REFORM

A. Regulation of Money Market Funds

Money market funds—which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost—serve as an effective cash management tool

[32] *See* Bair Testimony, *supra* note 25.

for retail and institutional investors, and are an exceptionally important source of short-term financing in the U.S. economy.[33] These funds have been comprehensively regulated by the SEC—not only under the Investment Company Act, but through a specialized and highly proscriptive rule, Rule 2a-7, for 30 years. In March, ICI, working through its Money Market Working Group, issued a comprehensive report outlining a range of measures to strengthen the liquidity and credit quality of money market funds and ensure that money market funds will be better positioned to sustain prolonged and extreme redemption pressures, including mechanisms to ensure that all shareholders are treated fairly if a fund sees its net asset value fall below $1.00.[34]

Consistent with the Working Group's recommendations, the Administration's white paper specifically directed the SEC to move forward with plans to strengthen the money market fund regulatory framework to reduce the credit and liquidity risk profile of individual money market funds and to make the money market fund industry as a whole less susceptible to runs.[35] ICI is pleased that the Administration recognizes that the SEC, as the primary regulator for money market funds, is uniquely qualified to evaluate and implement potential changes to the existing scheme of money market fund regulation. Indeed, last month the SEC proposed amendments to rules that govern money market funds.[36] The proposed amendments, many of which are similar to the Working Group's recommendations, are designed to make money

[33] *See* Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Speech at the Council on Foreign Relations, Washington, D.C.: Financial Reform to Address Systemic Risk (March 10, 2009) (acknowledging the importance of money market funds and the crucial role they play in the commercial paper market, a key source of funding for many businesses).

[34] *See Report of the Money Market Working Group*, Investment Company Institute (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[35] *See* Administration white paper, *supra* note 2, at 38-39.

[36] *See Money Market Fund Reform*, SEC Release No. IC-28807 (June 30, 2009), 74 FR 32688 (July 8, 2009), available on the SEC's website at http://sec.gov/rules/proposed/2009/ic-28807.pdf.

market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share. ICI looks forward to submitting comments on this proposal.

The Administration's white paper also directed the President's Working Group on Financial Markets to prepare a report assessing whether more fundamental changes are necessary to further reduce the money market fund industry's susceptibility to runs, such as eliminating the ability of a money market fund to use a stable net asset value or requiring money market funds to obtain access to reliable emergency liquidity facilities from private sources.[37] The white paper, however, cautioned both the SEC and the President's Working Group to carefully consider ways to mitigate any potential adverse effects of a stronger regulatory framework for money market funds, such as investor flight from money market funds into unregulated or less regulated money market investment vehicles.[38] ICI wholeheartedly agrees with this cautionary language and would be pleased to offer our assistance to the President's Working Group as it reviews these difficult issues.

B. Close Regulatory Gaps

Examination of the recent financial crisis has prompted calls for Congress to close regulatory gaps to ensure appropriate oversight of all market participants and investment products. We recommend that the SEC be given express authority to regulate in certain areas where there are currently gaps that have the potential to impact the capital markets and market participants, and to modernize regulation that has not kept pace with changes in the

[37] *See* Administration white paper, *supra* note 2.

[38] *Id.* at 39.

marketplace.[39] ICI supports reforms for these purposes in the areas discussed below, many of which are addressed in the Administration's white paper.

Hedge funds and other unregulated private pools of capital. ICI concurs with the Administration that the SEC should have express regulatory authority to oversee hedge funds (through their advisers) with respect to, at a minimum, their potential impact on the capital markets and other market participants.[40] Requiring hedge fund advisers to register under the Investment Advisers Act of 1940, as the Administration has proposed, would provide the SEC with reliable, current, and meaningful information about the hedge fund industry without adversely impacting the legitimate operations of hedge fund advisers.[41] Many ICI member firm complexes—all of whom are registered with the SEC—currently operate hedge funds and have found that registration is not overly burdensome and does not interfere with their investment activities.

If such a registration requirement is put into place, the SEC may wish to consider the adoption of specific rules under the Advisers Act that are tailored to the specific business practices of, and market risks posed by, hedge funds. Areas of focus for such rulemaking should include, for example, disclosure regarding valuation practices and the calculation of investment performance; both of these areas have been criticized as lacking transparency and presenting the

---

[39] Although not necessitating legislative action, another area for reform is the regulation of credit rating agencies. ICI has long supported increased regulatory oversight, disclosure, and transparency requirements for credit rating agencies. We participated at a roundtable held by the SEC on the oversight of credit rating agencies in an effort to further the discussion on ways in which to improve ratings and the ratings process. *See* Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, dated April 15, 2009, available at http://www.sec.gov/comments/4-579/4579-15.pdf.

[40] It is imperative, of course, that the SEC be organized and staffed, and have sufficient resources, to **e**ffectively perform this oversight function.

[41] ICI supported the SEC's 2004 adoption of a rule requiring hedge fund advisers to register with the SEC. In June 2006, this rule was struck down by the U.S. Court of Appeals for the D.C. Circuit.

potential for abuse. It also may be appropriate for the SEC to require nonpublic reporting by hedge fund advisers of information such as investment positions and strategies that could bear on systemic risk and adversely impact other market participants.

To enhance regulatory oversight of the hedge fund industry, some have advocated requiring SEC registration of individual hedge funds.[42] ICI strongly opposes this approach, because it would blur what has been a strict dividing line between registered, highly regulated investment companies and unregistered, lightly regulated hedge funds.

Under current law, hedge funds are effectively outside the purview of the Investment Company Act by reason of Sections 3(c)(1) and 3(c)(7), which require that the hedge fund is not making or proposing to make a public offer of its securities and that those securities be sold only to certain specific groups of investors. These statutory limits on both the offer and the sale of hedge fund securities work together to ensure that hedge funds are made available only to financially sophisticated investors who should not need the comprehensive protections afforded by Investment Company Act regulation and who should be able to bear the risk of loss associated with their investment.

Despite clear statutory language precluding a hedge fund from "making or proposing to make a public offer of its securities," there have been several occasions in the recent past where the hedge fund industry has argued that it should be able to advertise through the public media, provided that sales of shares are made only to financially sophisticated investors. ICI firmly believes that any form of general solicitation or public advertising of unregistered hedge funds would surely cause investors to confuse such funds with registered, highly regulated investment companies. It also would present greater opportunities for perpetrators of securities fraud to identify and target unsophisticated investors. We accordingly recommend that the current "no

[42] *See, e.g.*, S. 344, "The Hedge Fund Transparency Act" (introduced Jan. 29, 2009).

public offering" requirement be reconfirmed in any legislation enacted to regulate hedge funds or their advisers.

No less critical is the need to preserve the current requirement that interests in hedge funds be sold only to financially sophisticated investors. To this end, ICI believes that the SEC should immediately adjust the accredited investor standards in Regulation D under the Securities Act of 1933 (which determine investor eligibility to participate in unregistered securities offerings by hedge funds and other issuers) to correct for the substantial erosion in those standards since their adoption in 1982. This one-time adjustment should be coupled with periodic future adjustments to keep pace with inflation. ICI also continues to support the SEC's 2006 proposal to raise the eligibility threshold for individuals wishing to invest in hedge funds organized under Section 3(c)(1) of the Investment Company Act. Under that proposal, an individual would need to be an "accredited investor" based upon specified net worth or income levels, as is now required, and own at least $2.5 million in investments. This proposed two-step approach is intended to mirror the higher investor eligibility requirements for hedge funds organized under Section 3(c)(7), which Congress added to the Investment Company Act in 1996.

Derivatives. The SEC should have clear authority to adopt measures to increase transparency and reduce counterparty risk of certain over-the-counter derivatives, such as credit default swaps, while not unduly stifling innovation.[43] ICI supports current initiatives toward centralized clearing for certain derivatives, which should help to reduce counterparty risk and bring transparency to trading in the types of derivatives that can be standardized. Not all derivatives are sufficiently standardized to be centrally cleared, however, and institutional

[43] In its March white paper, ICI recommended a merger of the SEC and the CFTC. In the absence of such a merger, we believe that the SEC is the regulator best suited to provide effective oversight of financial derivatives.

investors will continue to need to conduct over-the-counter transactions in derivatives. For those transactions, we support reasonable reporting requirements, in order to ensure that regulators have enough data on the derivatives market to provide effective oversight and address any market abuses. Finally, we believe that all institutional market participants should be required to periodically disclose their derivatives positions publicly, as funds are currently required to do.

Municipal Securities. The SEC should be granted expanded authority over the municipal securities market, and should use this authority to ensure that investors have timely access to relevant and reliable information about municipal securities offerings. Currently, the SEC and the Municipal Securities Rulemaking Board are prohibited from requiring issuers of municipal securities to file disclosure documents before the securities are sold. As a result, existing disclosures are limited, non-standardized, and often stale, and there are numerous disparities from the corporate issuer disclosure regime.

This week, the SEC proposed several measures to improve current municipal securities disclosure. We are encouraged by these efforts but strongly agree with Chairman Schapiro that more will need to be done.[44] The SEC itself has stated on several occasions that it is near to the statutory limits of its present authority to address the disclosure needs of investors in municipal securities. "To provide investors in municipal securities with access to full, accurate, and timely information like that enjoyed by investors in many other U.S. capital markets, the [SEC] requires expanded authority over the municipal securities market."[45]

[44] *Opening Statement before the Commission Open Meeting*, Mary L. Schapiro, Chairman, Securities and Exchange Commission, July 15, 2009.

[45] *See* U.S. Securities and Exchange Commission, "Disclosure and Accounting Practices in the Municipal Securities Market," White Paper to Congress, July 2007.

VII. CONCLUSION

We appreciate this opportunity to testify before the Committee. Reforming the financial services regulatory regime in the wholesale manner envisioned by the Administration and Congress is a generational undertaking of the utmost import. It is vital that our collective efforts produce a new regulatory regime that protects investors and consumers, but also allows the U.S. financial services industry to thrive and evolve to meet investor and consumer needs for decades to come. We hope that our recommendations strike the proper balance between these important objectives. We look forward to working with this Committee and Congress to achieve these ends.